TOP

THE OPTION PROFIT

MAKING MONEY WITH STOCKS

BOOK I: INVESTING BASICS

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FORWARD

Thanks for reading “Basic Investing”, the first of three books in “The Option Profit Making Money” series. My intention with this book is to help investors understand necessary terms and implement strategies to increase returns, generate income as well as learn basic strategies to hedge, protect and navigate their investments.

Look for Book Two “Trading and Income” in the “Making Money” series to help basic and advanced investors understand, incorporate and profit from simple to complex strategies including the utilizations of dividends, margin, hedging and leverage to generate higher returns and income.

Also look for Book Three in the series “Making Money with Options.” In this book I’ll teach investors; novice to professionals, strategies geared specifically towards hedging, minimizing capital needed for investing and generating income without owning stock. Investors will learn to invest using Calls, Puts, Complex Option Strategies as well as other derivatives.

I encourage all readers to visit my site “Theoptionprofit.com” where you can leave a review sharing your stories of investing success.

INTRO

In the following pages, in no particular order, I will explain just a few of the many important tools an investor should have an understanding of regardless of whether it is your first trade or if you currently manage accounts. There are so many important factors to be considered, I apologize in advance if I haven't touched on a specific question you may have. If so, let me know and I will try to address them in future books.

TRADING

Trading is simply the exchanging of an item, tangible or intangible, for an agreed upon price. In the investment world there are many ways to accomplish this transaction and many ways to   restrict the transaction from occurring. Below is terminology every trader should understand.

Bid - The bid is the price a person interested in creating an opening position is willing to pay to buy a security. Like all things in the market the bid can fly around violently or sit so still and constant it is maddening. When you have highly volatile stocks flying around on the exchange in which they trade, moving sharply up or down, you won't be able to keep up with the change in the bid. When you have a market doing very little you may see no movement in the bid for days. A good example of an idol bid can be found in the options market. If you watch the deep out of the money (the stock price is noticeable above or below the strike price) bid of an option there is a high probability you will get frustrated before it moves.

Ask = The ask is the price a person interested in creating an opening position is willing to sell a security. All things with the bid hold true for the ask. You can see rapid movement or what seems like a dead stand still in a securities ask price.

Spread =The spread is the difference between the bid and ask. The stock broker who brokers the trade between the person offering the bid and the person selling at the ask generally keeps this as the fee for bringing the parties together. With the dramatic increase of technology the spreads have shrunk to less than a penny on many heavily traded stocks. Before electronic trading buyers and sellers were dependant on having someone facilitate the trade which gave the broker a nice advantage. When they were on the exchange floor and you werent they could find the widest spread in the bid and ask available to execute the trade. Of course, it was the broker's obligation to act in the manner most prudent for their client...sleep well since we all know greed has no place in the stock market. Fortunately for all investors alike spreads have shrunk in most areas of the market. You may still find a large spread in securities that have very little trade volume but that is a little more understandable. Think pink sheets.

Market = A market order simply means you are willing to pay what the buyer or seller of the security is asking at the time the trade is entered. A buyers market order will fill (be executed) at the current ask price conversely, a seller's trade will fill at the current bid price. As an example let's say you are trying to buy 100 shares of XYZ and the bid (price being off) is 1.00$ while the ask (price at which someone is willing to sell) is 1.02$. When you enter your market order to buy 100 shares of XYZ you pay 1.02$. Enter an at the market to sell order and you're paid 1.00$.

Limit = When you place a limit order you are trying to buy or sell at a specific price. In our above example XYZ is trading with a bid of 1.00$ and an ask of 1.02$ but you feel you will be able to sell your shares for,or are unwilling to accept less than, 1.05$ You will enter a limit order for 1.05$

and will only sell your shares if the bid on XYZ reaches 1.05$. On the opposite side of the trade there was an entity willing to buy at the market ask price of 1.05$ or they had in place their own limit order to pay no more than 1.05$ for XYZ.

Day = Placing a day order simply means you place an order which expires at the end of the trading day if it doesn't fill. You want to buy our XYZ, current ask price 1.00$, at 0.95$ but only if you can buy it before the NYSE, (New York Stock Exchange) where it is listed and trades, closes at 4:00 pm EST. If the ask price of XYZ doesn't drop to 0.95$ by 4:00 then the order expires and you go home not owning XYZ. I say 4:00pm when referring to the major US stock market exchanges but there are a few days during the year which are, or follow, holidays where the market closes before 4:00.

At The Close = When you enter an "at the close" order you are trying to buy/sell your shares as near the close of the market as possible. For example, when you place a buy "at the close" order on the New York Stock Exchange you are willing to pay the current ask price as close to 4:00 pm as possible while still allowing time for the trade to be executed. Of course the opposite side of that trade is you are willing to sell at the current bid price as close to 4:00 pm as possible.

At The Open = See above...substitute the work open for the word close. In the case of the major US stock markets we are talking 9:30am EST. Tokyo would be 9:00 am - 11:30 am reopens 12:30pm - 3:00 pm Tokyo time. London would be 8:00am - 4:30 pm London time. Hong Kong shares our work schedule, 9:30am - 4:00pm Hong Kong time. Australia would be 10:00am - 4:00pm Australian time and Russia would be 9:30am - 7:00pm Russian time.

For those in the United States Eastern Standard Time Zone (not daylight savings time) this means:

London - 5 hours ahead
Russia - 8 hours ahead
Hong Kong - 13 hours ahead
Tokyo - 14 hours ahead
Australia - 16 hours ahead

Good 'Til Cancelled = When you enter a Good 'Til Cancelled (GTC) order you have entered an order which commits you to sell or an offer to buy a security until you cancel the order, it executes or expires whichever happens first. The time frame for most Good 'Til Cancelled orders is typically 90 days on the US markets. Let's say you want to buy XYZ, currently trading at 1$, but are only willing to pay 0.95$ you enter a GTC order offering to buy XYZ at 0.95$ or better. You have now created a bid for and are committed to paying up to 0.95$ for XYZ should it trade there or below before you cancel the order or the GTC timeframe expires. Let's say a week later the market opens way down and XYZ, which closed at 1.00$ the day before, opens at 0.90$. Your GTC order will execute and you will buy your shares at 0.90$.

All or None = An all or none trade means you aren't willing to buy or sell your security unless the entire trade can be filled. It isn't uncommon for a partial fill to occur when you enter an order to buy 100 shares of XYZ at 1$ and there is a person on the other side of the trade willing to sell shares at 1$ but only has 50 shares to offer. You buy that entities 50 shares and are light the remaining 50. If XYZ doesn't trade down to 1$ the rest of the day your order expires and you own 50 of the 100 shares you were attempting to buy. An all or none trade ensures that doesn't happen. It is worth mentioning that if you have an GTC order and only 50 shares are purchased the order is still in effect so the other 50 will fill if the stock drops to 1$ before the trade expires.

T + 3 = Also known as settlement date. T + 3 simply means the buyer of a security has three business days to pay for and the seller has three days to produce the security. The 3 part of T + 3 begins the 1st business day following the trade. For example, you do the trade on Friday and the markets are closed Monday. Your 1st day is Tuesday and you have to have fulfilled your part of the transaction by Thursday.

STOCK

By definition stock is the capital raised by a business or corporation through the issue and subscription of shares. Stocks are known by and followed by their ticker symbol.

For illustration purposes shares in our imaginary widget making company have the ticker symbol XYZ.

Shares in our XYZ, once trading in the open market, can be bought and sold by anyone not precluded from doing so. Stock typically trades on an exchange and there are exchanges all over the world. When trading a stock the buyer offers a bid to buy price, the seller offers an ask to sell price with the difference between the two being the spread. This is commonly referred to as the bid/ask and is the way most investable transactions are quoted. The spread, or the difference between the bid/ask, is the amount the person/exchange brokering the transaction retains. For example, if a trader is able to broker a deal where I'm willing to pay 11$ (bid) for shares of XYZ and a current shareholder is willing sell her shares for 10$ (ask) he will keep the 1$ (spread). You will also find informative definitions of these terms and more in the free downloadable Glossary on the site.

The transaction has been completed, once the buyer has agreed to the ask price, the seller has agreed to the bid price and the shares change ownership. Once executed and you've become an investor. Unlike many transactions funds don't have to actually change hands at the point of sell. In fact, the buyer could turn around and sell the stock without paying for the shares. This type of transaction involves settlement date (think day trade), which I explain later in the book. In addition the security has to be marginable. A marginable security is any security that can be borrowed against. Margin is a little more complicated and is described in the "Making Money with Stocks" book in the series.

There is a wide ranging variety of stocks. Stocks can be defined by size of the company, tradability, availability of an exchange where the shares can be traded or even by the type of shares offered by the company itself. Below are the most frequently referred to types of stock:

Common stock - These shares represent ownership in a company and any dividend paid on a portion of profits. Dividends tend to vary based on a company's profitability and decisions on how they choose to use their profits. Dividends are not guaranteed. In addition, one share provides an investors one voting right of the company. An example of a shareholders use of their vote might be to elect board members to oversee management of the company. The size of the company has an impact on the stock. There are several categories that stock fall into depending on their value determined by size known as Market Capitalization (mkt cap). For example, our XYZ has 10 shares of stock with a share price of 100$ which calculates shares x price = a market cap of 1k.

Large Cap Stocks - Companies with market capitalization of more than 10 billion dollars. As mentioned above you calculate the market cap of a company by calculating the number of shares outstanding by the current stock price. An example of a well known large cap stock is Apple Computer. As I type this Apple is currently the largest of the large cap stocks with a market capitalization of 723 billion. A company's market cap increases or decreases every time the stock price changes.

The only guarantee in the stock market is there are no guarantees. However, large cap stocks tend to be the least volatile in part because often the are financially more stable companies and trade on reputable liquid stock exchanges. A liquid exchange means shares are available to trade and tend to have a reasonable bid/ask price. Large cap stocks tend to have more cash on their balance sheets and can afford to ride out economic downturns more easily than companies with market capitalization of less than 10 billion, which we talk about below. The larger the company, the more arrows it has in its quiver when it comes to reducing cost and tightening their belts (ie... layoffs, postponement of new products, issuance of bonds with lower interest rates or a reduction in its annual dividend). Smaller companies have a more challenging time with these types of actions and typically suffer from more noticeable stock price swings when forced to take such steps.

Midcap Stocks - Short for middle capitalization mid-cap stocks have a market capitalization between 2 and 10 billion. The value of the stock is reached by multiplying the number of the company's shares outstanding by the current trading price. For the middle of the road risk taking investor this is a good way to gain a little exposure to potential higher upside with less potential exposure to sharper downturns or bankruptcies than smaller cap stocks may face. Although they may not have the cash on reserves or the ability to take quite as many steps in the face of an economic downturn they are less risky and typically a little more stable than their smaller capitalized counterparts. An example of a mid-cap stock many may have heard of would be Boston Beer (SAM). Boston beer makes Samuel Adams and Angry Orchard Cider. At the time of publishing SAM has a mkt cap of 2.8 billion.

Small Cap stocks - The definition of a small capitalization stock varies between investment firms but is typically in the range of 300 million to 2 billion. Here too, the value is reached by multiplying the number of shares outstanding by the current price at which the stock is trading. When you begin to get below the 2 billion range for a stock's market cap the risk begins to increase. Investing in, or trading, small cap stocks is one of the riskiest way to invest in publicly traded stocks and should be thought through carefully. You should consider age, income level, time frame and need for income, among other things, before buying small cap stocks. Typically, the younger you are and the higher your income, the more you can afford to risk on your investments. I would encourage any investor to keep his/her exposure to small cap and more risky investments to a percentage in line with their age and investment goals. An example, a 25 year old making 100k yearly could be more comfortable investing 20% of his/her investable funds into risky securities, like penny stocks, where as a 75 year old on a fixed income probably shouldn't consider an investment in this type of risk. The lucky (or smart) investor who invests in solid small cap companies and sticks with them through their development can really benefit. That said, it is fairly unlikely that your small cap stock investments will turn you into "buy-your-own-island" rich.

Penny Stocks - A stock valued at less than 1$ and considered very risky. This type of stock comes with serious speculation. I would only invest in a penny stock with money you can afford, and expect, to lose. That said, some of the largest of large cap companies started out as penny stocks and grew into made lots of people rich stocks. The odds of winning a triple crown are higher than hitting, and holding on to, one of the few magical penny stocks that grow up to be a large cap stock. Personally I consider this more of an expensive hobby than investing.

Pink sheet stocks - These are over-the-counter (OTC) stocks that that do not need to meet minimum requirements or file with the Securities Exchange Commission (SEC). The pink sheets got their name because they were actually printed on pink paper. You can also tell if a company trades on these pink sheets because it will end in ".PK." These stocks don't trade on a stock exchange but instead have market makers who provide bid and ask prices. The market makers bring buyers and sellers together by providing a platform where Pink Sheet stocks can be traded. The prices are quoted in a daily publication compiled by the National Quotation Bureau. These are most commonly referred to as OTC stocks. These make penny stocks look like a solid investment. There is little volume in most of these stocks which can make for large gaps between the bid and ask on a percentage basis. Due to the lack of volume it can be difficult to enter into or exit out of an OTC stock with any uniformity. You could see a noticeable move in your favor in an OTC stock but not be able to profit from it because the market maker places such a big gap between the bid and ask. Frankly put, these OTC stocks are all too often fraudulent or marked in a way that benefits the market makers at the expense of the investor or are just a gamble.

All that said, there is an investor for all stocks and with enough homework, ongoing due diligence and luck one can make money regardless of the company. After all, all investments go up or down and there is someone one either side... someone will profit.

International stock - These are shares of stock that trade on companies based outside of your home country. This is, of course, a revolving definition depending on the country where you currently reside when you trade the stock.

Emerging Market Stock - These are stocks that are traded companies in emerging areas such as South Korea, Turkey or India just to name a few. Stock that is considered emerging market stock represents business in a country that is developing but is potentially being built on a fragile economy, governmental control or a near dictatorship. Other things to take into account when considering an emerging market investment is the country's population, climate, natural resources and living conditions. This type of stock has a place in your portfolio just as any other. However, this type of stock falls into the "more risk for potentially higher returns" category. Any investor should only assume as much risk as they can afford to lose regardless of the potential for higher returns.

Preferred stock - This type of stock provides the owner with some form of ownership in the company but generally has no voting rights. Generally the owner receives a dividend (a cash payout per share owned...explained later in the book) with a higher than average yield in lieu of voting rights. An example may be that company XYZ has a common share that yields a dividend of 2%, they may issue a preferred share with a yield of 6% but no voting rights.

Class - Common and Preferred are the two main forms of stock but a company can issue different classes to accomplish certain objectives. For example, a company may issue a class A and a class B share. They may give the class A share more voting rights than those allotted the Class B shares. This allows a minority group of shareholders to control the majority of the voting rights. These shares are generally denoted with an "a" or "b" behind the ticker symbol. ie, XYZa or XYZb.

OPTIONS

Time value of money(TVM) - Before discussing options I need to stress that one, if not the most, important thing an option buyer should consider is the time value of money. I explain in detail in my next book on option trading but simply put option premiums are calculated based on several criteria, one of which is their declining value over time. In addition to the TVM, be aware of company events such as earnings and dividends which will have an effect on the price movement of the underlying stock

Calls - A call option is a contract that gives the buyer the right to buy, and the seller an obligation to sell, an asset at an agreed upon price on or before a specified date. One call option contract equals 100 shares of the underlying stock. In general calls are traded with the expectation the stock will move higher. Most options expire on the third Friday of the month but there are exceptions. One exception is the VIX, which measures volatility and is discussed later in the book. VIX options expire on the third wednesday of each month. Another exception is quarterly options which expire on the last day of the quarter.

Lets look an example of a call option. Say our XYZ is trading at 18 and Julie has sold 10 July 20 strike call options collecting a 0.50$ premium. If, at any point upto and including the third friday of July, XYZ trades above

20 anyone who bought a 20 strike call option can exercise and buy, from Julie, XYZ at 20. If XYZ goes to 250$ Julie has to sell 1k shares to the person on the other side of the trade for 20$.

If Julie owns 1k shares of XYZ she has sold a covered call, discussed later in the book. If she doesn't own 1k shares of XYZ she has sold a naked call and will go short 1k shares of XYZ if the option is exercised. Going short is a little more complicated and is defined in the next book in my series. Either way Julie realizes 20.50$ per share since she collected the 0.50 call premium.

To profit from an option you don't have to exercise your contracts. In our example let's say you are the person on the other side of Julie's trade. You paid 0.50$ for her July 20 calls when XYZ was trading at 18. You get lucky and XYZ trades up 1$ to 19 the next day causing the calls you bought at 0.50$ to rise in value to 1$. After doing the happy dance you simple sell the 20 strike calls you purchased at 0.50 for 1$ to exit or "close" the trade having doubled your money overnight.

Puts - A put option is a contract that gives the buyer the right to sell, and the seller an obligation to buy, an asset at an agreed upon price on or before a specified date. Like calls one put option contract equals 100 shares of the underlying stock. Typically puts are traded around an expected move lower in a stock. Expiration dates, as well as those with exceptions, are the same for puts as calls.

There are a variety of places on the internet to find information regarding expiration, last day to trade and exchange holidays. One site I use to find information around dates involving option trading is CBOE.com. In addition to standard options you'll find dates important to ETF, ETN, Quarterly and Vix options as well as LEAPS. LEAPS (Long Term Equity Anticipation Securities) are a trading tool I explain in another book in the Making Money with Stock Series.

Lets use Jake and his 10 July 20 strike price XYZ put contracts he bought for 0.50$ as our example. By purchasing the put Jake is anticipating a decline in the price of XYZ. If XYZ trades below 20 on or before expiration Jake can exercise his put contracts forcing someone on the other side of the trade to buy his XYZ at 20$. Theoretically Jake can exercise his put at anytime regardless of XYZ stock price but it wouldn't make a lot of sense to exercise the put when XYZ is trading at 25$ (or any amount over 20$) per share. If Jake owns 1k shares of XYZ the put protects him against a move below 19.50$ a share (10.50$ instead of 20$ because he paid 0.50$ for the put), if he doesn't own 1k shares of XYZ he will typically keep the put contracts until expiration date so the stock is protected. If XYZ is trading at 10$ on the third Friday of July (expiration) Jake can:

1. Do nothing and he will automatically sell his XYZ at 20$
2. Sell his Put contracts for 10$ effectively reducing his XYZ cost basis by 9.50$
3. Roll the option. (described in detail in future series rolling is a small step more complicated but essentially is taking this month's profit and spending some of it for protection out to a future date).

The same principle holds true when profiting from a put option without exercising the contract. Our guy Jake bought the 20 strike XYZ put for 0.50 when XYZ was trading at 20. The next day XYZ drops to 19 causing the premium for the 20 strike put to increase to 1$. Same happy dance then sells his contracts exiting the trade doubling his money overnight.

Both puts and calls are commonly sold to generate income in an anticipated horizontal market move. Both are also commonly sold to protect against or bought to participate in an anticipated vertical market move.

From a simple covered call trade to the most complex strategy option trading has become a tremendous asset for investors to utilize in so many different aspects of their portfolios and financial planning. The volume and popularity in option trading has ballooned. I personally feel options are one of the most important tools any investor can incorporate into his/her portfolio, including IRA's. I explain all areas of option trading from market protection, profiting from volatility, generating income to low cost high return strategies with unlimited upside potential in short periods of time in the option trading book in my series.

INDEXES

S&P 500 - So, now that we have gone over large cap, mid cap, small cap, penny and OTC stocks let's look at indexes. An index is a measure of a specific group of a market. Typically an index is weighted based on size of the investments which comprise the index. An index is often used to compare returns against individual investments (often considered to have more risk) or investment managers. Indexes can be formed to cover just about any group of investments you wish and can be prepared and traded in many ways. The typical investor may choose to invest in an index mutual fund or ETF (which we will define shortly). The most commonly known indexes are the DOW Jones, the S&P 500, the Nasdaq and the Russell 2000. Lets look at the S&P 500 to get a great example of how a stock index works. This index is comprised of the 500 largest market cap stocks that are listed and have stock that trades on, the NYSE

(New York Stock Exchange) or the NASDAQ (National Association of Securities Dealers Automated Quotations). This index is weighted and is comprised of 10 weighted sectors. These sectors are:

1. Consumer Discretionary
2. Consumer Staples
3. Energy
4. Financials
5. Health Care
6. Industrials
7. Information Technology
8. Materials
9. Telecommunication Services
10. Utilities

A company's weighting in the index is the percentage it makes up of the index as a whole. As I am typing this, Apple Inc. (AAPL) has the largest weighting on the index of 4.06%, with Meredith Corp. (MDP) having the smallest at 0.014%. An equal percentage move in AAPL stock would have a more noticeable impact on the S&P 500 than the move in MDP shares.

There are unweighted index ETFs that track the S&P 500, along with most other indexes, in which any rise or decline in an individual stock has the same impact regardless of company size. The S&P 500 is the index most professional and personal investors use as a way to track progress in stocks overall.

Dow Jones 30 - Another index often tracked is the Dow Jones Industrial Average (DJIA). Unlike the market value weighted S&P 500 this index is price weighted. Criteria for entry is pretty vague but the index is comprised of 30 of the largest companies in the US across many industries with the exception of transports and utilities...both of which have their own indexes. In today's modern trading times you really can find an index to track a wide variety of investments. This index was first calculated on May 2th 1896 and was comprised of 12 industrial stocks. Here we are 118 years later and General Electric (GE) is still in the index. It is the only remaining stock from the original 12 industrial stocks, which has now grown into 30 industrial stocks.

NASDAQ 100 - This index is comprised of 104 stocks actually, 104 of the largest non-financial companies listed on the NASDAQ. It is also a weighted index and is commonly known for being tech heavy when it comes to the types of companies within the index. Stocks trading on the NASDAQ, like Microsoft (MSFT) for example, will typically trade with 4 symbols.

Russell 2000 - This index is actually a subset of another index, The Russell 3000 representing approximately 10% of the total market cap of the index. This index is comprised of roughly 2000 of the smallest securities based on both market cap and current index membership. The purpose of the index is to serve as a comprehensive unbiased barometer for small cap stocks. The index is reconstituted annually to rid itself of any stocks that may have outgrown its remaining 1999 peers.

These are the four main indexes followed by the equity investment community. There are many many indexes and you can find one that will track just about anything you want tracked. You can track healthcare to finance to technology to biotech to regional banks to transportation, and the list goes on.

EXCHANGE TRADED FUNDS (ETF'S)

Exchange traded funds are essentially a basket of stocks, index investments, commodities investments, currency investments, bond investments, leveraged investments, triple leveraged investments...you get the picture. Exchange Traded Funds are liquid and can be traded daily like common stock in the market. Most investors view ETFs as a more conservative way to invest in markets by eliminating the risk of owning an individual security. There are way too many ETFs to begin to describe so I comprised a list of 111 of them you can download free at my site (theoptionprofit.com).

As a general rule most traders agree leveraged (especially triple leveraged) ETFs should be used as a short term trading vehicle. The cost involved with these ETFs will prevent their movement from being consistently in line with the investment they are designed to follow. In my opinion, they will ultimately decrease in price...but, with sharp market moves, can go up or down dramatically as they decline over time.

MUTUAL FUNDS

A mutual fund is an investment funded by shareholders and overseen by a portfolio manager. You can typically tell a mutual fund by the the fact that it trades under a 5 letter ticker symbol. I am not going to dive deep into mutual funds, since this book is geared to the stock trader, but do want to mention them since many funds invest for their shareholders in the types of stock we've discussed. Mutual funds are considered a more conservative long term investment. They are not designed for, and probably shouldn't be used for, short term trading. So many diverse funds are offered one could fill a long term investment portfolio with mutual funds exclusively and have exposure to stocks across all investment fields. An investor could buy shares of mutual funds that invest in bonds, options, futures, currencies, precious metals and other derivatives. They usually have a front end fee along with a yearly management fee or a time frame commitment. With the time frame commitment you can avoid the upfront fee and are generally charged a lower annual management fee as long as you stay invested. For any funds you withdraw prior to the agreed upon time period you pay a declining backend fee. Typically the declining time period is 5-7 years. With ever increasing competition there are more and more funds charging reduced or no upfront fees, called no load funds. There are also index funds and proprietary funds that can be purchased without an upfront fee and without being locked into a declining time period fee.

DIVIDEND

A dividend is paid when a company distributes a portion of earnings to shareholders. The board of directors is usually the governing body over this decision. The dividend is generally quoted in terms of the dollar amount each share receives (dividends per share). It can also be quoted as a percent of its current market price (dividend yield).

Yield - Let's say our XYZ is trading at 10$ per share and it pays a dividend of 1$. This means you will receive 1$ for every one share you own. You may hear it stated as XYZ pays a dividend of 1$ per share. You may also hear it stated as XYZ has a dividend yield of 10%. The 1$ dividend divided by the 10$ stock price equals the yield.

Many investors look at dividend yield when considering an investment. Generally speaking, a stock paying a higher dividend is considered a value stock and tends to be a little less volatile than those considered growth stocks. A retiree may look for higher dividend paying stocks to supplement their retirement income. Often a person searching for a higher dividend yield is willing to give up a potentially higher increase in the stock price over time.

Dividend reinvestment - Investors may reinvest the dividends back into the stock. This allows them to buy additional shares of a company without coming out of pocket with their own money. For example let's say you bought one share of XYZ which is trading at 1$ per share and pays a dividend of 1$. By reinvesting, the dividend will buy one share of XYZ. You now own 2 shares of XYZ and have used your stock, not your own money, to buy the second.

Dividend dates - There are three important days involving the dividend which I explain in detail in the next book in my series. These days are:

- Ex-dividend
- Record date
- Payable date

USING STOCK TO GENERATE INCOME

There are many tools an investor can use to create or generate income. For example, bonds (corporate, government, municipalities, convertible and a host of others), preferred stock, dividends,shorting dividends, naked and covered calls/puts etc... I explain these and more in detail in the next book in my series but for now lets discuss two of the most common methods.

Dividends - are generally at the top of the list of things an investor measures when looking for a stock they hope to use for generating income. Typically you would look for a stock with a higher yield that has continuously raised their dividend year after year. In addition to a high dividend yield you would generally look for a stock with a low beta (explained in the next chapter) . As mentioned above, this investor is willing to forgo excess potential stock appreciation for what they feel will generally be a less volatile higher dividend yielding investment.

Covered calls - Covered call writing translated means selling an option on a stock you own. When you sell the covered call option you are taking a premium (the price someone pays you to buy the option) in exchange for the right to buy your shares at a certain price. Options are generally referred to as contracts and one contract most often translates into 100 shares if exercised (the person who bought the call option exercises their right to buy your 100 shares of stock). Options have an expiration date which, with most stocks, is the third Friday of each month. If the option that was purchased has no value on this date the sellers obligation expires. This is a relatively simple series of transactions and a great way to generate extra income if you own shares of a company you are willing to sell at a certain price.

Lets use a basic example. Investor A buys 100 shares of XYZ at 100$ and sells the 105$ May call option for 1$. Investor A receives 100$ while investor B, who bought the option, receives the right to buy the 100 shares of XYZ at 105$. If, by the third Friday in May XYZ is trading below 105$ the option expires, investor A keeps the 100$ and no longer has an obligation to sell investor B his 100 shares of XYZ at 105$. If, however, XYZ is trading at 110$ on expiration Friday investor B can exercise his option and buy investor A's 100 shares for 105$.

There is an effect on actual cost basis (and theoretical cost basis) when option premiums are received and lead to stock trading hands. For our purpose, investor A used his 100 shares of XYZ to generate 100$ of income.

These are two examples of the 7 strategies I cover in detail in the next book in the The Option Profit "Making Money With" series.

BETA

A measure of the volatility of a security or a portfolio in comparison to the market as a whole.

For example, let's say our XYZ has a beta of .5 which simply implies if the stock market, where that beta is listed, moves 1% the stock should move ½%. You should never invest in a stock based on beta alone because there are any number of factors that may happen causing beta to change rapidly.

Let's say our XYZ, with a beta of .5, announces earnings (how much money the company made in a quarter). If they do really well and earn more than expected the stock may move up 2% even though the market only moves 1%. Other factors that could affect a company's beta include things such as the announcement of a special one time dividend, Pre-announcing they aren't going to earn as much as expected when they report earnings or announcing another company has offered to buy them for a price higher than they are currently trading. There are many other actions which could affect beta and should consider before investing. Beta should simply be used as a gauge of how volatile our XYZ may be. If you are someone who wants a very low risk investment you would look for a stock with a low beta.

Beta can also be used to gauge how volatile your portfolio as a whole may be. Let's say you have ten stocks in your portfolio. If you add the beta of all ten stocks, then divide by ten, you get your portfolio's average beta. If the average beta is .02 you have a pretty low risk portfolio which shouldn't move as dramatically as the market when sudden drops are spikes occur.

Many stocks, for example utility companies, tend to have a low beta, while offering a higher dividend yield, when compared to other stocks. In addition to providing income investing in low beta, high dividend yielding stocks may provide your portfolio with a level of stability during sudden market downturns. In short, the low beta investor is willing to trade the potentially higher return of the market overall for income probable stability. Not uncommon to see older investors employ this strategy.

CONCLUSION

In this version of my “Making Money With” series I have touched on some basics. For more detail, annotation and examples of these and many other financial market terms, including both simple and complex stock and option trading strategies, look for other books in the series, “Making Money with Stocks”.

Be sure to visit my site for more educational content and explanations that will help any investor make money with stocks, options, dividends, hedges and more.

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I OFFER THESE HUMBLE THOUGHTS…

Rich is to have money
Wealth is to have happiness
In life we have one heart, two eyes
live in the present keeping one eye on the past the other on the future